United States General Accounting Office

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Report to the Chairman of the Subcommittee on Military Readiness, Committee on National Security, House of Representatives

March 1997

# NAVY ORDNANCE

# Analysis of Business Area Price Increases and Financial Losses

GAO
**United States**
**General Accounting Office**
**Washington, D.C. 20548**

**Accounting and Information**
**Management Division**

B-274841

March 14, 1997

The Honorable Herbert H. Bateman
Chairman, Subcommittee on Military Readiness
Committee on National Security
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review financial and operational management issues relating to the Navy ordnance business area which was included in the Defense Business Operations Fund (DBOF). On December 11, 1996, the Under Secretary of Defense (Comptroller) reorganized DBOF and created four working capital funds: Army, Navy, Air Force, and Defense-wide. The Navy ordnance business area is now part of the Navy Working Capital Fund. The four working capital funds will continue to operate under the revolving fund concept and charge customers the full costs of providing goods and services to them. Since the Navy ordnance business area still operates under the revolving fund concept, our findings and recommendations are applicable under the working capital fund structure.

The financial information on the operation of this business area shows that there are several key reasons for about $212 million of reported losses experienced from fiscal year 1994 through fiscal year 1996. In particular, most of these losses were attributable to actual overhead costs exceeding budgeted overhead costs. This situation has caused significant price increases that ultimately result in reduced purchasing power for the military services' operations and maintenance appropriation dollars. We are concerned that excessive operating costs may exist in many of the Department of Defense's (DOD) logistics business activities and may be causing substantial amounts of operation and maintenance appropriations to be used inefficiently. As discussed with your office, we will be looking at additional DOD business activities to determine the extent of this problem.

We are sending copies of this report to the Ranking Minority Member of your Subcommittee; the Chairmen and Ranking Minority Members of the Senate Committee on Armed Services; the Senate Committee on Appropriations, Subcommittee on Defense; the House Committee on Appropriations, Subcommittee on National Security; the Senate and House Committees on the Budget; the Secretary of Defense; the Secretary of the Navy; and the Director of the Defense Finance and Accounting Service. Copies will also be made available to others upon request.

If you have any questions about this report, please call Greg Pugnetti at (202) 512-6240. Other major contributors to this report are listed in appendix II.

Sincerely yours,

Jack L. Brock, Jr.
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# Executive Summary

## Purpose

The Chairman, Subcommittee on Military Readiness, House Committee on National Security, asked us to determine why the Navy ordnance business area increased prices 78 percent from fiscal years 1994 through 1996 and incurred about $212 million in losses during that 3-year period. The Chairman also asked us to determine whether management has accurate and consistent financial management information for effectively managing the Navy ordnance business area.

On December 11, 1996, the Under Secretary of Defense (Comptroller) reorganized DBOF and created four working capital funds: Army, Navy, Air Force, and Defense-wide. The Navy ordnance business area is now part of the Navy Working Capital Fund. The four working capital funds will continue to operate under the revolving fund concept—using the same policies, procedures, and systems as they did under DBOF—and charge customers the full costs of providing goods and services to them. The Comptroller made this change to clearly establish the military services' and DOD components' responsibilities for managing the functional and financial aspects of the business areas.

## Background

The Navy ordnance business area provides various services, including ammunition storage and distribution as well as the maintenance of missiles, to customers who consist primarily of Defense organizations but also include foreign governments. During fiscal year 1996, the business area sold about $563 million of services to its customers—primarily commands and activities of the military services. For financing purposes, the business area is part of the Navy Working Capital Fund, which is a revolving fund that relies on sales revenue rather than direct congressional appropriations to finance its operations. Revolving funds are supposed to generate sufficient revenues to cover the expenses incurred in their operations. In fact, the revolving funds are expected to operate on a break-even basis over time—that is, not to make a profit nor incur a loss, but simply to recover all costs.

The Navy ordnance business area generates revenue by billing customers at predetermined prices as it performs specifically agreed upon work for those customers. The prices are to be based upon anticipated actual costs. Customers primarily use operations and maintenance appropriations to pay for this work. Payments from customers replenish the Navy Working Capital Fund's working capital, which is used to finance subsequent operations. The ordnance business area is expected to operate within the revenue it generates. Conceptually, this provides an incentive to control costs and maximize efficiency. It is essential that the business area operate efficiently since every dollar spent on the Navy Working Capital Fund's infrastructure is one less dollar available for other defense spending priorities.

## Results in Brief

The business area's price increased from $50.02 per direct labor hour in fiscal year 1994 to $89.03 per direct labor hour in fiscal year 1996—a 78 percent increase. A large part of this price increase was due to the inclusion of significant overhead costs in the prices charged customers—costs that were previously paid for through direct appropriations or by Navy major commands. Even though the prices increased, the business area reported it lost about $212 million during fiscal years 1994 through 1996, and would have lost more if it had not been allowed to increase its prices in order to recoup prior year losses. These losses primarily occurred because (1) actual overhead costs that the business area was responsible for exceeded budget projections and (2) the business area received lower-than-expected workload levels which prevented it from generating enough revenue to recover its budgeted overhead costs. These rising prices and consistent losses ultimately reduce the purchasing power of the customers' appropriations.

The Navy's implementation of DBOF and its reorganization to consolidate ordnance functions have resulted in more costs being identified and included in the prices charged customers. This has helped to identify areas of inefficient operations within the business area that contribute to the price increases—principally overhead costs. However, the Navy ordnance business area still needs to take a number of actions to ensure that accurate and consistent information is available to effectively manage the business operations. Specifically, we found that the business area (1) did not accurately forecast the amount of work to be performed, (2) used a pricing structure that did not allow individual ordnance activities to charge prices that represented their estimated cost of doing business, and (3) did not accurately budget and account for costs.

# Principal Findings

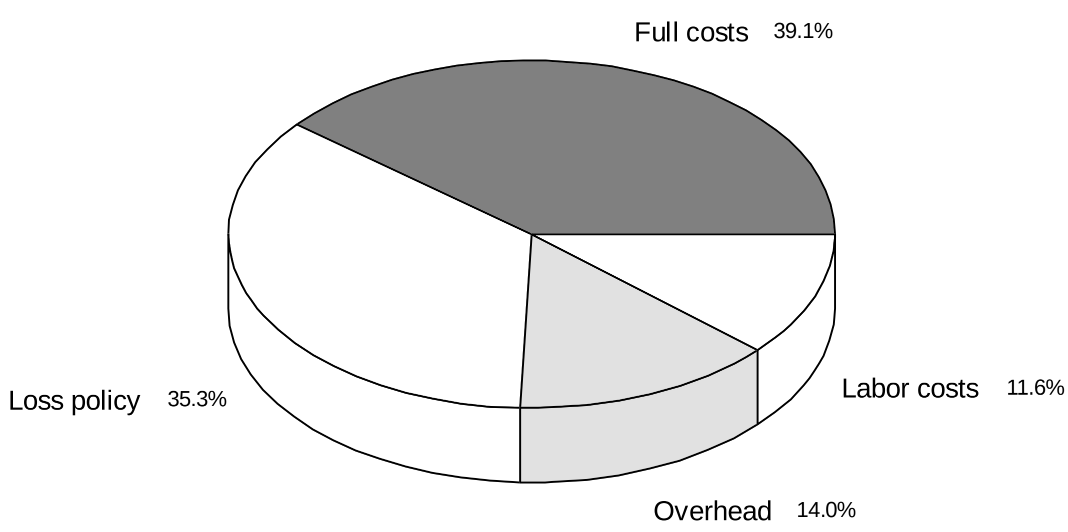
## Factors Contributing to Price Increases

The Navy ordnance business area's composite sales price[1] increased from $50.02 per direct labor hour (DLH) in fiscal year 1994 to $89.03 per DLH in fiscal year 1996. We found that

- $15.25, or 39.1 percent, of the per hour increase was due to efforts to ensure that prices more accurately reflect the full costs of the Navy ordnance operations;
- $13.79, or 35.3 percent, of the per hour increase was attributable to DOD's policy that requires prices to be adjusted to recover prior year losses or return profits (most prior year losses occurred because actual overhead costs exceeded budgeted overhead costs);
- $5.46, or 14.0 percent, of the per hour increase stemmed from overhead costs being allocated over a declining workload; and
- $4.51, or 11.6 percent, of the per hour increase was due to increases in direct labor costs.

Figure 1 illustrates the percentage of price increases by category.

**Figure 1: Factors Contributing to Price Increases**




[1]The composite sales price is the average amount that customers must pay for a direct labor hour.

In developing the fiscal year 1996 prices, the Navy ordnance business area did a better job of identifying the total costs of its operations and factoring those costs into the prices. Specifically, in determining fiscal year 1996 prices, the Navy identified and included about $87 million of estimated costs that were not included in fiscal year 1994 prices. These were costs incurred for military security guards, headquarters personnel, and underutilized plant capacity. By including these additional costs in the prices, the business area is now in a better position to identify the full costs of its operations. Only through the identification of the full costs of operations can management—DOD and the Navy—begin to make more informed decisions on the appropriate action needed to reduce infrastructure costs.

Also, in accordance with DOD's policy, the Navy ordnance business area increased fiscal year 1995 and 1996 prices to recover prior years' operating losses. Navy ordnance officials stated that DOD's policy causes major price fluctuations from one year to the next and drives some customers to seek other sources for the work. To illustrate the potential magnitude and impact of this problem, they pointed out that the estimated accumulated loss at the end of fiscal year 1997 is expected to be about $220 million. To recoup this loss within a year, the Navy could (1) add $49 an hour to the fiscal year 1998 prices—a 60-percent increase over the fiscal year 1997 prices—or (2) request a direct appropriation of $220 million. DOD and the Navy decided to increase the prices charged customers for ammunition storage and distribution to recover these losses.

Further, because customers are ordering less work, the Navy ordnance business area is allocating its overhead costs over a continually declining workload base. From fiscal year 1994 through fiscal year 1996, the number of budgeted DLHs decreased from 6.9 million to 5.7 million—a 17 percent decrease. During this same period, the business area's actual overhead costs did not decrease proportionately with the decline in workload. As a result, more overhead costs are being allocated to each direct hour. This operating environment of declining workload and increasing prices is one of the most critical challenges DOD currently faces. Three years ago, the Under Secretary of Defense (Comptroller) referred to this environment as a "vicious circle" and said it was the single largest threat to DBOF. According to the Comptroller, DOD's inability to reduce infrastructure costs as fast as customer budgets are being reduced is at the center of the dilemma. Since customers are paying higher prices for needed goods and services and they have a finite amount of funds, their overall demand for work is decreasing.

## Factors Contributing to Losses

The Navy ordnance business area reported losses of about $212 million for fiscal years 1994 through 1996 and would have lost more had it not added surcharges to its fiscal year 1995 and 1996 prices. These losses can be attributed to several factors, but they primarily resulted from overhead costs exceeding budget projections. In fact, the actual reported overhead costs in fiscal years 1994 and 1995 were about $201 million higher than budget estimates. According to GAO's analysis and Navy ordnance officials, these higher-than-expected overhead costs occurred because (1) DOD's pricing policy required the business area to absorb unanticipated cost increases of at least $87 million, which were previously paid for by other appropriations or major commands, and (2) the Navy ordnance business area did not achieve savings goals that were incorporated into its budgets by Navy and DOD budget officials.

Further, because prices charged customers are based on projected workload, workload shortfalls adversely impacted the financial results of the Navy ordnance business area. GAO's analysis of budgeted and actual DLHs for fiscal years 1994 and 1996 showed that the business area performed about 900,000 fewer DLHs of work than it budgeted. The lower-than-expected workload levels forced the business area to shift many of its direct labor employees into overhead positions, and resulted in not generating sufficient revenue to cover fixed overhead costs. The workload shortfalls resulted in about $39.8 million in losses for the 2 years.

In addition, the Navy ordnance business area lost about $13 million related to using Naval reserve forces to support its ordnance mission from fiscal years 1994 through 1996. In accordance with DOD policy, the business area bills customers for actual hours of work performed by the reserves but reimburses the Reserve Personnel, Navy appropriation at the budgeted amount. The budgeted hours should be based on realistic estimates of the amount and type of work that the reserves will be able to accomplish. However, the actual labor performed by the reserves for ordnance related work was a reported $13 million less than the amount that the Navy ordnance business area reimbursed the Reserve Personnel, Navy appropriation.

## Effective Management Requires More Accurate and Consistent Information

While the Navy ordnance business area has improved the availability of information needed to manage the business area by including more of the relevant costs in the prices charged customers, it still lacks accurate and consistent information on the amount of work to be performed and the cost of performing that work. This information is essential to a revolving fund operation since (1) revenue is based on the amount of work performed and the price charged for that work and (2) revenue should approximate the cost of performing the work if the revolving fund is to operate on a break-even basis.

## Recommendations

We are making recommendations to the Secretary of Defense and the Secretary of the Navy for improving the Navy ordnance business area's operations, price-setting, and financial management practices. These recommendations focus on (1) the Navy developing a plan to streamline the Navy ordnance operations and reduce its infrastructure costs, including overhead, (2) setting prices based on realistic estimates of work to be performed, (3) setting prices that are based on costs expected to be incurred by individual Navy ordnance activities, and (4) ensuring that costs, especially overhead costs, are accurately allocated to the customers benefitting from the services.

## Agency Comments

In its written comments on this report, DOD stated that overall the report reasonably depicts the business activities of Navy ordnance and agreed with three of our four recommendations. It did not agree at this time with our recommendation on setting prices based on costs expected to be incurred by individual activities. DOD cited the need to complete two initiatives in order to more fully consider this recommendation. It expects these initiatives to be completed by August 1, 1997. As part of the congressionally mandated initiative to study working capital funds, DOD indicated that it plans to evaluate the desirability of establishing individual activity prices. As part of this evaluation, DOD needs to consider the incentives that individual activities have for operating efficiently and reducing costs.

# Contents

## Appendixes



## Tables



## Figures



### Abbreviations

| | |
|---|---|
| DBOF | Defense Business Operations Fund |
| DFAS | Defense Finance and Accounting Service |
| DLH | direct labor hour |
| DOD | Department of Defense |
| GAO | General Accounting Office |
| MTIS | materials turned into stores |
| NOC | Naval Ordnance Center |
| NWAD | Naval Warfare Assessment Division |

# Introduction

When Defense established the Defense Business Operations Fund (DBOF) in 1991, it was attempting to fundamentally alter the way DOD manages its resources by fostering a more business-like culture within selected defense operations. DBOF, a revolving fund financial structure, was essentially an extension of the stock and industrial funds that have operated within DOD for about 45 years. One of the primary goals of DBOF was to identify the total costs of operations and to highlight the cost implications of management decisions. The Navy ordnance business area has operated under the industrial fund concept since 1953 and became part of DBOF when it was established in 1991. On December 11, 1996, the Navy ordnance business area became part of the Navy Working Capital Fund when the Under Secretary of Defense (Comptroller) dissolved DBOF. The Comptroller reorganized DBOF to clearly establish the military services' and DOD components' responsibilities for managing the functional and financial aspects of their respective business areas. The Navy Working Capital Fund will continue to operate under the revolving fund concept and charge customers the full costs of providing goods and services to them as currently defined in DOD's Financial Management Regulation, Volume 11B, Reimbursable Operations, Policy and Procedures—Defense Business Operations Fund.

## Why Industrial Funds Were Established

During the 1940s, the Hoover Commission, while studying abuses in government operations, found that the military budget and appropriation processes were highly inefficient. For example, the Commission found that managers at industrial activities did not know the cost of individual jobs and, therefore, concentrated on obtaining funds to support their existing programs rather than improving the efficiency of their operations. Similarly, the Commission found that, because industrial activities' customers were not charged for the work performed, they were seldom constrained by financial considerations.

To correct problems such as these, the Congress, in 1949, amended the National Security Act of 1947 to authorize the establishment of industrial funds.[1] In establishing the funds, the Congress intended to introduce the discipline and incentives of private industry and commerce to DOD industrial activities and their customers. Industrial funds were expected to improve government operations by establishing a buyer-seller relationship between fund activities and their customers. The fund activities would be financially dependent on obtaining orders and matching costs with reimbursements. Consequently, they would be motivated to (1) improve

[1]This authorization is now found at 10 U.S.C. 2208.

cost estimates and controls and (2) identify and correct inefficiency and waste. Customers would pay for services rendered and would, therefore, be motivated to order only necessities.

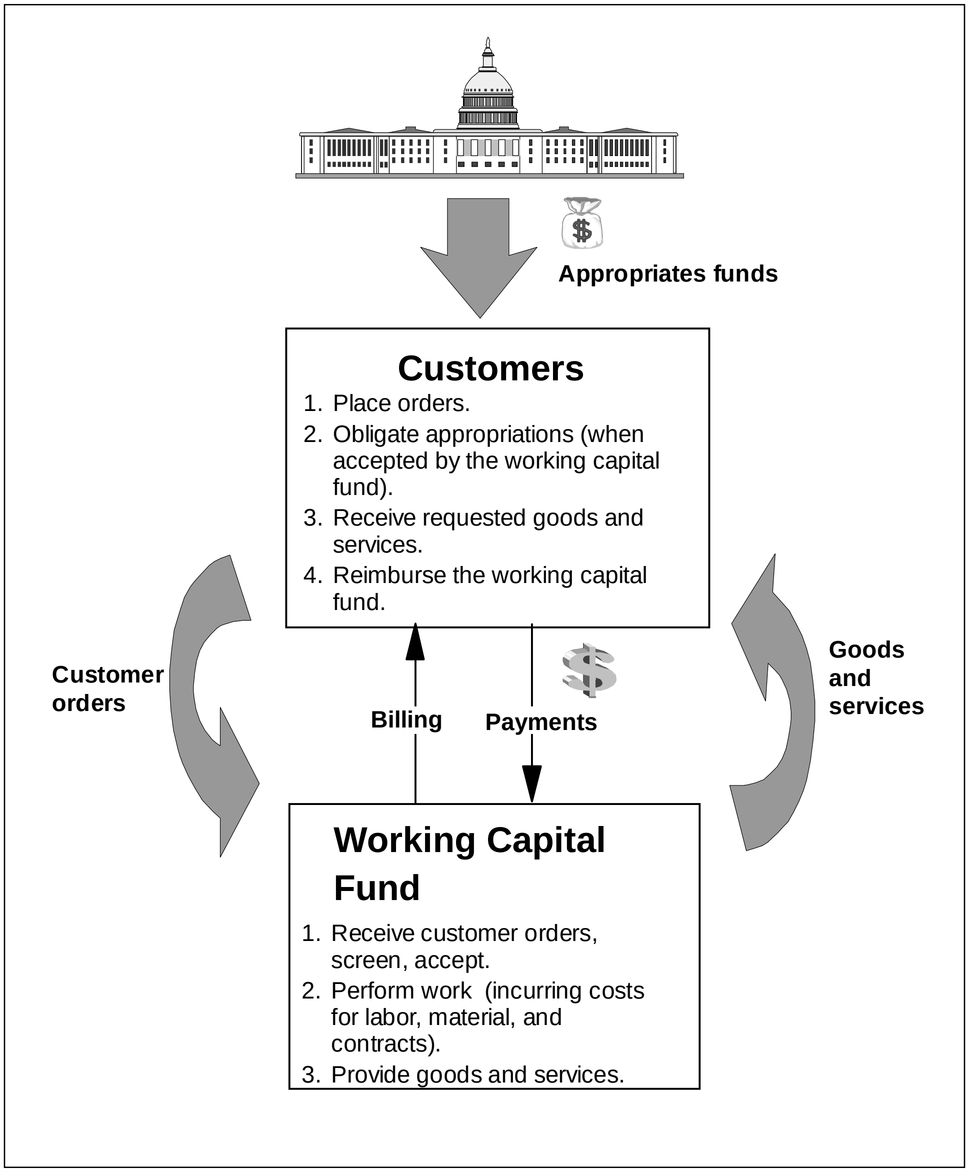
## DOD Established DBOF

In October 1991, DOD established DBOF, which consolidated the nine existing industrial and stock funds operated by the military services and DOD, as well as the Defense Finance and Accounting Service, the Defense Industrial Plant Equipment Service, the Defense Commissary Agency, the Defense Reutilization and Marketing Service, and the Defense Technical Information Service into a single financial structure. The military services and DOD components continued to be responsible for managing and operating the business activities within this financial structure. DBOF's fiscal year 1996 revenue of about $81 billion made it equivalent to one of the largest corporations in the world.

Under the recently established four working capital funds, the business areas will continue to operate the same way they did under DBOF. DBOF's primary goal and that of the current working capital fund structure is to focus the attention of all levels of management on the total costs of carrying out certain critical DOD business operations and the management of those costs in order to encourage support organizations, such as maintenance facilities, to provide quality goods and services at the lowest cost. Accomplishing this will require DOD managers to become more conscious of operating costs and make fundamental improvements in how DOD conducts business. Unlike a private sector enterprise which has a profit motive, the objective of DBOF and the four working capital funds is to operate on a break-even basis by recovering the costs incurred in conducting the business operations. It is critical for business areas to operate efficiently since every dollar spent on infrastructure is one less dollar available for other defense spending priorities. The business areas provide essential goods and services needed for maintaining military readiness including the (1) overhaul of ships, tanks, and aircraft and (2) sale of over 5 million types of vital inventory items such as landing gears for aircraft.

DBOF received its initial working capital of $6.5 billion through a transfer of resources from the nine existing industrial and stock funds in 1991. As figure 1.1 illustrates, the business areas used these resources to finance the initial cost of providing the goods and services that are ordered by their customers. Customers use appropriated funds, primarily Operation and Maintenance appropriations, to finance these orders. Thereafter, as the business areas perform work and incur costs, they bill customers on the basis of predetermined prices—commonly referred to as standard or stabilized prices. Payments from customers are then used to finance subsequent operations, much as sales revenues are used in commercial enterprises.

Figure 1.1: Working Capital Fund Operations



## Business Areas' Budget and Price Setting Process

Present DOD policy requires the business areas to establish prices that allow them to recover from their customers the expected costs, including any prior years' losses. The business areas are to establish prices before the start of each fiscal year and apply these predetermined prices to most orders and requisitions received during the year. Because sales prices are based on expected costs and workload, (1) higher-than-expected costs or lower-than-expected customer demand for goods and services can cause business areas to incur losses and (2) lower-than-expected costs or higher-than-expected customer demand for goods and services can result in profits. Therefore, in order for a business area to operate on a break-even basis, it is extremely important that the business area accurately estimate the work it will perform and the costs of performing the work.

The process that business areas use to develop their stabilized prices begins as early as 2 years before the prices go into effect, with each business area developing workload projections for the budget year. After a business area estimates its workload based on customer input, it (1) uses productivity projections to estimate how many people it will need to accomplish the work, (2) prepares a budget that identifies the labor, material, and other expected costs, and (3) develops prices that, when applied to the projected workload, should allow it to recover operating costs from its customers.

Major commands responsible for the overall management of the various business areas review and consolidate individual business area activities' budget estimates. The military services' and DOD components' headquarters and the Office of the Secretary of Defense review the consolidated estimates before they are submitted to the Congress as part of the annual budget. Any changes made during the DOD budget review process are incorporated into the business areas' prices before the start of the fiscal year.

## Navy Established the Naval Ordnance Center

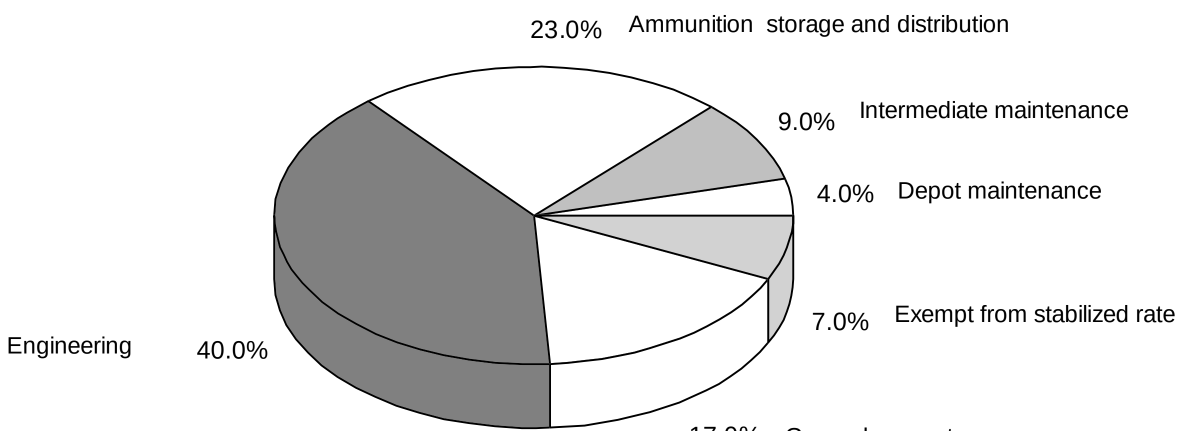
In October 1993, the Navy reorganized the Navy ordnance business area and established the Naval Ordnance Center (NOC) in order to address various ordnance logistics management deficiencies that had been identified during Desert Shield/Desert Storm operations and by various working groups and studies. These deficiencies included (1) unresponsive support to the fleets, (2) a fragmented inventory management function that made it difficult for the fleets to identify the people who could resolve their ordnance problems, and (3) an information system that did not give managers adequate visibility over ordnance. The creation of NOC was expected to alleviate these problems and to allow the Navy to use a streamlined and integrated ordnance team to "provide the right ordnance, in the right quantity and condition, to the right customer, at the right place, at the right time, and at the right cost."

The establishment of NOC was also expected to save about $173 million annually—primarily by consolidating ordnance support functions previously performed by the Naval Air Systems Command, Naval Sea Systems Command, Naval Supply Systems Command, and five fairly autonomous Naval weapons stations. The $173 million in savings would be shared by these components. Specifically, the Navy expected to save most of the money by transferring ordnance-related headquarters functions from the three systems commands to NOC Headquarters, transferring most of the weapons stations' administrative functions to two new divisions (Atlantic and Pacific Divisions), and consolidating in-service engineering support for ordnance items. Currently, the Navy ordnance business area consists of NOC Headquarters and the Atlantic and Pacific Divisions described above; five Naval weapons stations; two weapons station detachments; the Naval Warfare Assessment Division; and the Inventory Management and Systems Division. NOC's activities and their locations are shown in figure 1.2.

Figure 1.2: Naval Ordnance Center Activities


Although this business area was called the Navy ordnance depot maintenance business area until December 1996, only 4 percent of the work preformed by the business area involves depot maintenance. DOD defines depot maintenance as material maintenance requiring major overhaul or a complete rebuilding of parts, assemblies, subassemblies, and end items. However, as shown in figure 1.3, one of the business area's core requirements and largest workloads—ammunition storage and distribution—involves the receipt, segregation, storage and issue of ammunition, as well as all services related to ammunition loading and unloading of naval ships and commercial vessels.[2] Other workloads include (1) ordnance engineering services, such as gauging the war fighting capacity of ships and aircraft—from unit to battle group level—by assessing the suitability of design and performance of weapons,[3] (2) general support, such as providing security, real property maintenance, and other base operations support services to the weapons stations' tenant activities, and (3) performing intermediate level maintenance, such as replacing defective ordnance components. Recognizing that this business area did not perform much depot maintenance work, DOD changed the name of the business area to Navy ordnance in December 1996.

**Figure 1.3: Navy Ordnance Workload as a Percent of Revenue**



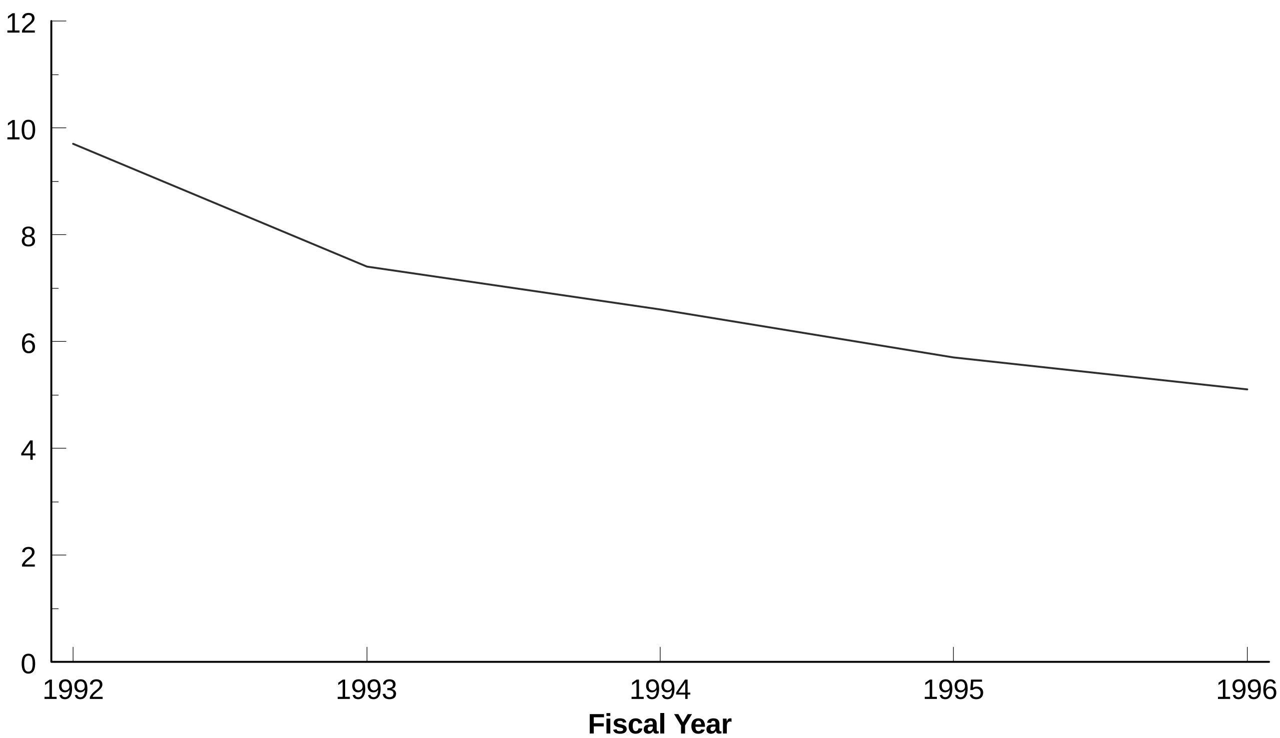

Over the last several years, the amount of work that this business area has received from its customers has steadily declined due to the downsizing and realignment actions that have been occurring throughout the DOD military force structure. As shown in figure 1.4, the amount of work

[2]See Defense Ammunition: Significant Problems Left Unattended Will Get Worse (GAO/NSIAD-96-129, June 21, 1996), for problems related to the storage of ammunition.

[3]This mission is accomplished by the Naval Warfare Assessment Division, which is located in Corona, California.

performed by NOC declined from a reported 9.7 million DLHS in fiscal year 1992[4] to 5.1 million DLHS in fiscal year 1996—a 47 percent decrease. At the same time, NOC has reduced its personnel from 8,904 to 5,363—a 40 percent reduction. While the number of personnel has decreased, it has not been proportional to the decrease in workload because of the difficulty involved in quickly releasing employees when the workload declines.

**Figure 1.4: Navy Ordnance Workload** (in Millions of Direct Labor Hours)




Source: Navy Ordnance Business Area.

## Objectives, Scope, and Methodology

The objectives of our audit were to determine (1) the causes of the Navy ordnance business area price increases that took place from fiscal year 1994 through fiscal year 1996, (2) why the Navy ordnance business area

[4] The amount of work performed in fiscal year 1992 was extraordinarily high due to Desert Shield/Desert Storm.

incurred about $212 million in reported losses during that 3-year period, and (3) whether management has accurate and consistent financial management information for effectively managing the Navy ordnance business area.

To determine what factors caused the prices to increase between fiscal years 1994 and 1996, we obtained and analyzed NOC's workload budgets for fiscal years 1994 through 1996 and compared them with actual workload results to identify variances from budgeted amounts. For identified differences, we met with responsible accounting and program officials to ascertain (1) why there were differences and (2) how the differences affected prices. We also analyzed the budgets for fiscal years 1994 through 1996 to determine the cost factors used in developing the prices. We met with responsible Navy comptroller and program officials at NOC Headquarters, the Atlantic and Pacific Divisions, and selected weapon stations to identify and discuss the rationale for the various factors used (or not used) to develop the Naval ordnance business area's prices it charged customers.

To determine what factors caused the Navy ordnance business area to incur about $212 million in reported losses from fiscal year 1994 through fiscal year 1996, we analyzed budget reports and related data for fiscal years 1994 through 1996 and compared budgeted direct and overhead costs to actual direct and overhead costs to identify variances from the budgeted amounts. For identified differences, we met with responsible accounting and program officials to ascertain (1) why there were differences and (2) how the differences resulted in losses incurred by the Navy ordnance business area.

To determine if management had accurate and consistent information for effectively managing the business area, we reviewed (1) workload forecasts to determine if they were accurate, (2) the NOC's uniform price concept and the impact that this practice has on the individual weapons station net operating results, and (3) the allocation of overhead costs to specific workloads to determine if they were accurate. We also reviewed DOD Inspector General and Naval Audit Service Chief Financial Officer reports on the business area's financial statements to identify any problems they may have found with the business area's financial information. We did not independently verify the financial information provided by the Navy ordnance business area.

We performed our work at the Office of the DOD Comptroller, Washington, D.C.; the Offices of the Assistant Secretary of Navy (Financial Management and Comptroller), Naval Sea Systems Command, Naval Air Systems Command, and Headquarters, Defense Finance and Accounting Service, all located in Arlington, Virginia; the Naval Ordnance Center Headquarters, Indian Head, Maryland; the Naval Ordnance Center Atlantic Division, Yorktown, Virginia; the Naval Ordnance Center Pacific Division, Seal Beach, California; the Naval Weapons Station, Yorktown, Virginia; the Naval Weapons Station, Charleston, South Carolina; the Naval Weapons Station, Earle, New Jersey; the Naval Weapons Station, Seal Beach, California; the Naval Weapons Station, Concord, California; and the Naval Warfare Assessment Division, Corona, California. Our work was performed from June 1996 through February 1997 in accordance with generally accepted government auditing standards.

DOD provided written comments on a draft of this report. We incorporated DOD's comments where appropriate. These comments are discussed in chapters 3 and 4 and are reprinted in appendix I.

# Factors Causing Prices to Increase

The Navy ordnance business area's composite sales price increased from $50.02 per DLH in fiscal year 1994 to $89.03 per DLH in fiscal year 1996, or about 78 percent.[1] As this chapter discusses, a large part of this increase—39.1 percent—was due to efforts to ensure that the business area's prices fully reflect the cost of providing goods and services to customers—a primary goal of working capital funds. About 50 percent of the price increase, however, was attributable to two other factors: (1) the Navy's compliance with a Defense requirement to reflect prior-year profits and losses in prices and (2) the spreading of overhead costs to fewer DLHS due to a rapidly declining workload. Each of the causes for the price increase are shown in table 2.1. Setting prices based on full costs allows business area managers to make more informed policy decisions; however, they have also caused some ordnance customers to find other sources to perform their work at lower prices.

**Table 2.1: Major Causes of the Navy Ordnance Business Area's Fiscal Year 1994-96 Sales Price Increase**

| Cause of increase | Impact on rate | Percent of increase |
|---|---|---|
| Additional cost components captured that were previously financed by other appropriations or major commands | $15.25 | 39.1 |
| Prior year losses | 13.79 | 35.3 |
| Declining workload | 5.46 | 14.0 |
| Direct labor costs | 4.51 | 11.6 |
| **Total** | **$39.01** | **100.0** |

## Current Prices More Accurately Reflect Total Cost of Operations

The Navy ordnance business area has been working to implement DBOF and is capturing more of the total cost of its operations and reflecting those costs in the prices charged customers. As shown in table 2.1, our analysis indicates that $15.25, or about 39.1 percent, of the Navy ordnance business area's price increase from fiscal year 1994 to fiscal year 1996 was attributable to Navy and DOD efforts to ensure that all relevant costs were identified and included in the sales prices. Until the establishment of DBOF in October 1991, significant overhead costs were (1) contained in different organization structures and paid by different appropriations or major commands and (2) excluded from the prices charged customers. DBOF's total cost concept, along with the Navy's reorganization, consolidated Navy ordnance costs by shifting the costs from the different organization structures to the Navy ordnance business area. These previously excluded costs relate to (1) overhead and (2) underutilized plant capacity.

[1] If the fiscal year 1994 sales price is converted to fiscal year 1996 dollars, it would be $52.47 per direct labor hour. This would reduce the increase in price to 70 percent.

## Fiscal Year 1996 Prices Include New Costs

About $7.93 of the $15.25 price increase can be attributed to overhead costs that were included in the 1996 prices, but not the 1994 prices. These costs include

- $12.5 million for military security guards, which were previously financed by the Military Personnel, Navy appropriation ($2.19 per DLH);
- $11.9 million for Navy ordnance headquarters functions, which were previously financed by the Operation and Maintenance, Navy appropriation ($2.09 per DLH);
- $10.8 million for the Inventory Management Support Division, which was previously financed by DBOF's Navy supply management business area ($1.89 per DLH); and
- $10 million for functions related to explosive safety, nuclear security, ordnance handling, and sensitive ordnance security, which were previously financed by the Operation and Maintenance, Navy appropriation ($1.76 per DLH).

By including these additional costs in the prices, business area managers can more easily focus on and manage the relevant costs. In addition, the more accurate identification of costs should enable those responsible for providing oversight to make more informed policy decisions.

## Cost of Underutilized Plant Capacity Now Included in Sales Prices

Like many of the business areas, the Navy ordnance business area must always maintain the capability to meet rapid escalation of demand for its services in times of war or other military emergencies. A 1994 DOD policy change affected the way costs associated with maintaining this mobilization capability are financed and is responsible for $7.32 of the $15.25 price increase. According to the DOD Financial Management Regulation, Volume 11B, mobilization capability costs include costs to maintain a surge capability, to procure and maintain approved war reserve material levels, and/or maintain other assets, functions, or capabilities required to meet an operational contingency.

Under the old policy, if underutilized facilities, equipment, or infrastructure were needed in order to meet mobilization surge requirements, then the costs related to maintaining the underutilized assets were to be determined, budgeted, and financed by a direct appropriation—rather than as overhead costs that are incorporated into customers' sales prices. While the Navy ordnance business area used the facilities and equipment, that use was less than the full capacity of an operating facility.

However, under the new policy, the cost of maintaining these assets is not funded as a mobilization requirement unless the assets are expected to be unused for 6 consecutive months. This policy change also addressed concerns that the Senate Appropriations Committee raised in its reports on DOD's fiscal years 1994 and 1995 appropriations.[2] Specifically, the committee reports questioned the need for funding underutilized plant capacity and noted that using direct appropriations to subsidize Navy industrial maintenance facilities was contrary to the DBOF concept of capturing the full cost of operations.

## Prior Year Losses Increase Sales Prices

As noted previously, DOD policy requires business areas to adjust their prices in order to recoup accumulated losses from or return accumulated profits to their customers. In accordance with this policy, the business area decreased its fiscal year 1994 sales prices to return a profit of $38.1 million that was projected for the end of fiscal year 1993. Similarly, when it established the business area's fiscal year 1996 prices, the Navy increased its prices to recoup a loss of about $47 million that was projected for the end of fiscal year 1995. Following this policy resulted in a net increase of $13.79 per hour, or about 35 percent, of the price increase from fiscal year 1994 to fiscal year 1996.

To illustrate the potential magnitude and impact of including prior year losses in prices, Navy ordnance comptroller officials pointed out that their business area's accumulated loss at the end of fiscal year 1997 is expected to be about $220 million. To recoup this loss, the Navy could either (1) add about $49 to the fiscal year 1998 prices—a 60 percent increase over the fiscal year 1997 prices—an increase high enough to drive more customers away or (2) seek a $220 million direct appropriation. DOD and the Navy decided to increase the prices charged customers for ammunition storage and distribution to recover these losses.

## Declining Workload Creates Pressure to Increase Prices

Since the military forces have been downsizing over the last several years, the demand for Navy ordnance work has declined. However, the business area's overhead costs have not decreased proportionately to the decline in workload. This has caused the business area to allocate its overhead costs over a steadily declining workload base and, in turn, to allocate more overhead costs to each DLH of work that is accomplished. Our analysis indicates that workload reductions accounted for $5.46, or about 14 percent, of the price increase from fiscal year 1994 through fiscal year

[2]Senate Reports 103-153 and 103-321.

1996. The magnitude of these workload reductions affects the amount of budgeted overhead cost per DLH as illustrated in table 2.2.

Table 2.2: Budgeted Overhead Costs and Direct Labor Hours for Fiscal Years 1994 and 1996

| Fiscal year | Budgeted overhead costs (millions) | Budgeted direct labor hours (millions) | Budgeted overhead cost per DLH[a] |
|---|---|---|---|
| 1994 | $206 | 6.9 | $29.72 |
| 1996 | $200[b] | 5.7 | $35.18 |

[a]Price per hour may not be precise due to rounding.

[b]The total budgeted overhead cost was $287 million for fiscal year 1996. In order to compare the fiscal year 1994 and 1996 budgeted overhead figures, we adjusted the fiscal year 1996 figure by $87 million because (1) new overhead costs were added and (2) of a change in the financing of underutilized plant capacity.

## Higher Prices Result in Customers Shifting Work From Navy Ordnance Business Area

Due to higher prices, some customers are shifting work from the Navy ordnance business area to other sources. Customers are shifting work from the business area to nonworking capital fund activities that are not required to charge the full cost of doing business, such as not charging the cost of military personnel. Since the Navy ordnance business area is required to charge customers the full cost and nonworking capital fund activities are not required to do so, this situation creates a competitive disadvantage for the Navy ordnance business area. Further, some customers shifted work to other working capital fund activities that are capturing full costs but offering lower prices. Some examples follow.

- In one instance related to the calibration maintenance of the Mark 48 torpedo support equipment, we found that the work previously done by the Yorktown Weapons Station was now being done at an activity located at the Norfolk Naval base for about one third of the price. According to the commander of the Mark 48 torpedo maintenance facility, which was also located on the Yorktown Weapons Station, he paid the Norfolk Naval base about $40,000 during fiscal year 1996 for over 1,000 hours of work. The commander told us that if he had given the work to Yorktown, he would have been charged about $110,000 or about three times as much. The large difference in prices occurred because the Norfolk activity was not a working capital fund business activity and thus was not required to charge labor and overhead costs which Yorktown, being a working capital fund activity, had to charge. The Norfolk activity only charged the costs of pieces and parts needed to perform the calibration work on the torpedo support equipment.

- In another case, the Concord Naval Weapons Station lost about 103,000 DLHS of work related to the Air Force's prepositioned ships program that had been included in its fiscal year 1997 budget. Concord has performed this work, which involves loading and unloading ammunition ships, for the last several years. However, the Army's military ocean terminal at Sunny Point, North Carolina—which performed much of the work prior to 1993—won a formal competition for the work in fiscal year 1997. According to Air Force program managers, Concord was as qualified to do the work as Sunny Point. However, these managers said that a major factor in deciding to award the work to Sunny Point was that its $9.5 million bid was about $3 million less than Concord's bid. In discussing this matter with Concord officials, they indicated that the elimination of this workload will result in a loss of about $7 million—primarily because it will (1) prevent them from recouping about $6.5 million in fixed overhead costs and prior year losses, and (2) force them to place some of their workers into overhead positions for part of the year.
- We also found that the Naval Ships Parts Control Center, which was previously a Yorktown customer, transferred its workload related to the inspection and repair of various steam valves and other items of materials turned into stores (MTIS) by Navy submarines. According to the Acting Director of Ship Parts Control Center's MTIS program, the work was transferred to the Defense Distribution Depot Norfolk, also a working capital fund activity, primarily because Norfolk charged substantially less than Yorktown. For example, at the time of transfer on October 1, 1995, Yorktown was charging $180 to inspect and repair each lot of MTIS. This was about 200 percent more than the $61 per lot charged by the Norfolk Depot. The Director also told us that primary factors contributing to Yorktown's higher costs were the large amounts of overhead included in the prices and Yorktown's use of inspectors to perform the work as opposed to lower paid depot warehousemen at the Norfolk Depot.

The operating environment of declining workloads and increasing prices is common among many business areas and is one of the most critical challenges DOD currently faces. In an April 1994 testimony, the Under Secretary of Defense (Comptroller) referred to this environment as a "vicious circle" and indicated that DOD's inability to eliminate infrastructure costs as fast as customer budgets are being reduced is at the center of the dilemma. Specifically, he indicated that (1) higher prices are causing business area customers to reduce their demand for goods and services, (2) business areas are generally unable to reduce their costs quickly enough to respond to the reduced demand, (3) as a result, the business areas are incurring losses that, under current DOD policy, must be recouped through price increases, and (4) the price increases start the whole “vicious circle” over again. As shown above, the Comptroller’s statement is as valid today as it was 3 years ago and the Navy ordnance business area will continue to experience this “vicious circle” until it reduces its infrastructure costs.

## Conclusions

The Navy’s implementation of DBOF along with the reorganization to consolidate ordnance functions has helped ensure that the Navy ordnance business area’s prices reflect the total cost of doing business—a primary objective of DBOF and the recently established working capital funds. Setting prices based on the full costs of providing goods and services has increased prices which, in turn, has helped to (1) identify key areas contributing to inefficient operations within the business area, (2) highlight the cost implications of management decisions, and (3) provide managers with information for use in improving their operations. On the other hand, the increases have also caused customers to seek alternatives to the Navy ordnance business area. Improving the efficiency of Navy ordnance operations will help alleviate his problem. This concept is discussed more fully in the next chapter.

# Factors Contributing to Navy Ordnance Business Area Losses

The Navy ordnance business area reported it lost about $212 million during fiscal years 1994 through 1996, and would have lost more if it had not been allowed to add surcharges to its fiscal year 1995 and 1996 prices in order to recoup prior year losses. Although many factors contributed to these losses, our analysis indicates that they occurred primarily because the business area (1) had higher-than-expected overhead costs, (2) did not receive as much work as expected, and (3) had to pay for work that reserve component units were expected to perform, but did not. In determining the reasons for the losses, we compared budgeted information to actual information for fiscal years 1994 through 1996. Some of the reasons for the losses, such as unanticipated overhead costs related to headquarters activities, also contributed to the price increases that were discussed in chapter 2.

## Projected Operating Results Have Consistently Been Overly Optimistic

The annual DBOF budgets that have been submitted to the Congress have consistently contained overly optimistic estimates for the Navy ordnance business area's operating results. For example, due to the DOD policy that requires activities to use surcharges to recoup prior year losses from their customers, the business area was expected to earn a profit of about $47.7 million during fiscal year 1996; however, instead of making a profit, the business area reported it actually lost about $36.7 million during the year. Thus, these surcharges allowed the business area to reduce its losses and caused its performance to appear better than it actually was.

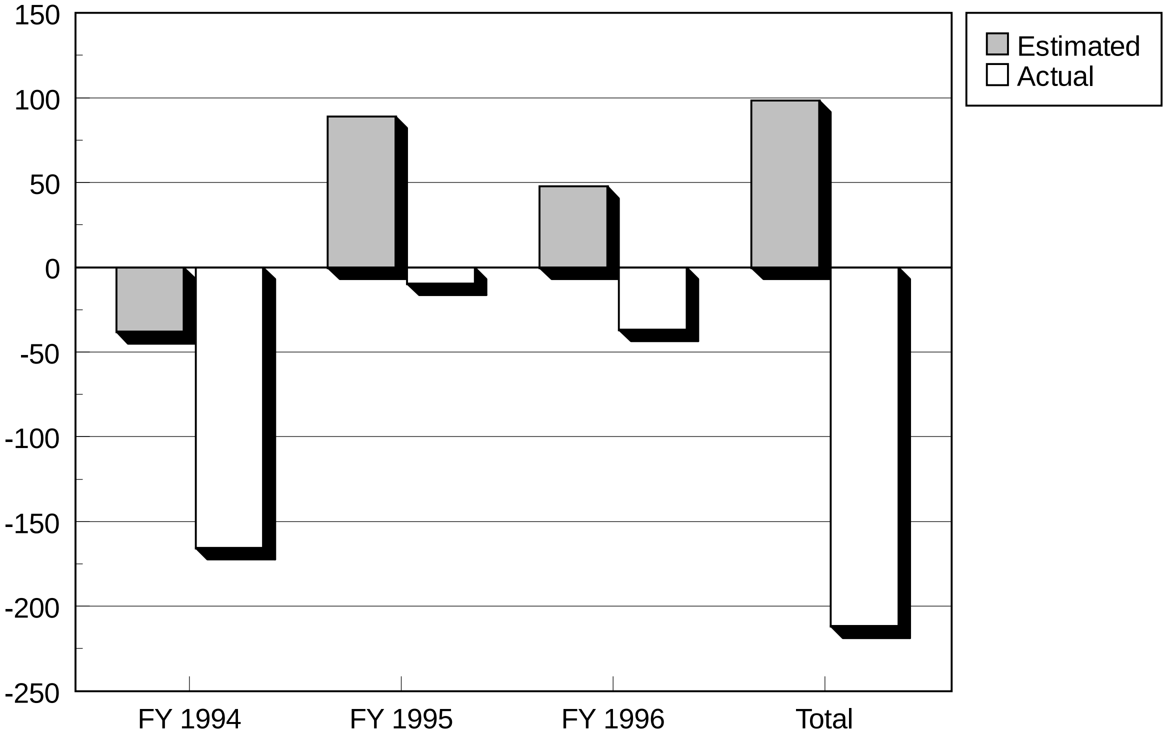
Altogether, the Navy ordnance business area was expected to earn a profit of $98.6 million during fiscal years 1994 through 1996. However, as shown in table 3.1 and figure 3.1, because the business area's performance was consistently worse than expected, it incurred a net reported loss of $211.8 million during the period.

**Table 3.1: Navy Ordnance Business Area's Budgeted (Estimated) and Actual Reported Operating Results for Fiscal Years 1994-96**

Dollars in millions

| 1994 | | 1995 | | 1996 | | Total | |
|---|---|---|---|---|---|---|---|
| Budget | Actual | Budget | Actual | Budget | Actual | Budget | Actual |
| ($38.1) | ($165.5) | $89.0 | ($9.6) | $47.7 | ($36.7) | $98.6 | ($211.8) |

**Figure 3.1: Estimated** (Budgeted) **vs. Actual Results**




Source: Navy Ordnance Business Area.

## Overhead Costs Have Been Much Higher-Than-Expected

The primary cause of the business area's losses is that overhead costs have been much higher than expected. Specifically, as shown in table 3.2 and figure 3.2, actual reported overhead costs for fiscal years 1994 through 1996 were about $197.5 million,[1] or about 29 percent, higher than budget estimates. Because the (1) budgets are prepared 18 to 20 months before the beginning of the fiscal year and (2) Navy ordnance business area reorganized in October 1993, the business area could not accurately estimate overhead costs for fiscal years 1994 and 1995, as we discussed in chapter 2. For fiscal year 1996, the business area was better able to

[1]About $63 million of this difference is due to the fact that the Navy ordnance business area did not receive the underutilized plant capacity funding it had budgeted for in fiscal year 1994.

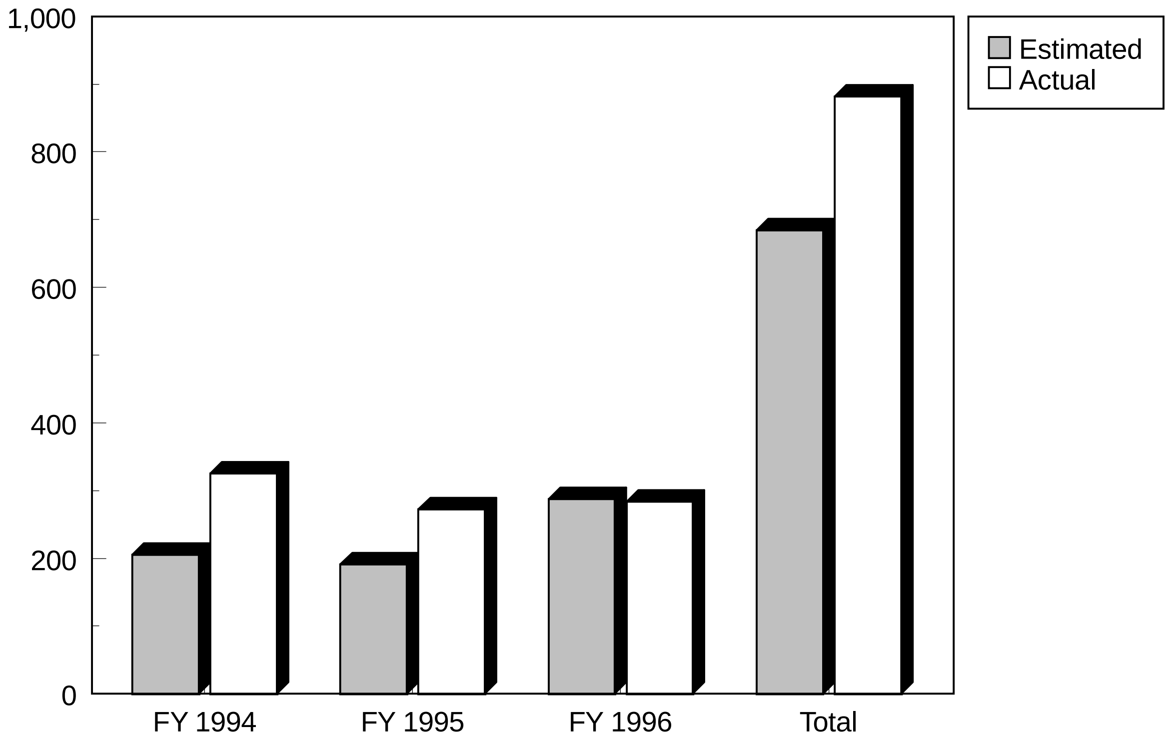
estimate overhead costs since it had been in operation under its new organizational structure for about 1 year.

**Table 3.2: Navy Ordnance Business Area's Budgeted and Actual Reported Overhead Costs for Fiscal Years 1994-96**

Dollars in millions

| 1994 | | 1995 | | 1996 | | Total | |
|---|---|---|---|---|---|---|---|
| **Budget** | **Actual** | **Budget** | **Actual** | **Budget** | **Actual** | **Budget** | **Actual** |
| $205.5 | $325.5 | $191.2 | $272.2 | $287.4 | $283.9 | $684.1 | $881.6 |

**Figure 3.2: Estimated** (Budgeted) **vs. Actual Overhead**




Source: Navy Ordnance Business Area.

According to Navy ordnance officials and our analysis, these higher-than-expected overhead costs were primarily due to three factors: (1) it incurred new and unanticipated costs that were previously financed with other appropriations or by the Navy's major commands, (2) the weapons stations did not achieve productivity and cost reduction goals that were incorporated into their budgets by Navy and DOD budget officials, and (3) it is difficult for managers to reduce the size of their workforce quickly enough to respond to declining workloads, especially when unanticipated workload shortfalls occur. When the business area is confronted with higher-than-expected overhead costs, it is precluded by DOD's price stabilization policy from passing on unanticipated cost increases—including overhead costs—to customers during the fiscal year.

## Business Area Absorbed Unanticipated Costs

DOD policy requires business areas to establish sales prices that allow them to recover their expected costs from their customers. It also requires them to establish their prices before the start of each fiscal year and to apply these predetermined or "stabilized" prices to all orders received during the year—regardless of when the work is actually accomplished or what costs are actually incurred. Because sales prices are based on expected rather than actual costs, higher-than-expected costs can cause a business area to incur losses and lower-than-expected costs can result in profits.

DOD established this "price stabilization" policy in 1975 to protect revolving fund customers from unforeseen inflationary increases and other cost uncertainties. The intent of the policy is to ensure that customers will not have to reduce their programs because of higher-than-expected prices. This policy should also allow customers to provide more reliable workload estimates to business areas which, in turn, should allow the activities to better plan for the efficient use of their resources. We agree with this policy since the policy protects appropriated fund customers from unforeseen changes. This enables the customers to buy goods and services from the four working capital funds as shown in the budgets presented to the Congress. For example, if a customer needed 100 engines overhauled, a change in the price may result in the customer only having enough funds to have 75 engines overhauled, thereby impacting the customers' readiness capability.

When a business area is confronted with higher-than-expected costs, it is precluded by DOD's price stabilization policy from increasing prices charged customers during the fiscal year. For example, the business area's fiscal year 1994 sales prices were based on the assumption that the cost of maintaining underutilized plant capacity (to meet wartime contingency requirements) would be financed through a transfer of $63.2 million from the Navy Operation and Maintenance appropriation; however, as discussed previously, this method of financing underutilized capacity was changed after the stabilized prices had been established and, as a result, the business area incurred the costs but could not pass them on to its customers.

Similarly, many costs related to the establishment of NOC were not included in the business area's fiscal year 1994 prices and, as a result, the business area incurred the costs but could not pass them on to its customers in that year. For example, Navy ordnance officials estimate that the business area lost about $16.9 million since the fiscal year 1994 prices were developed before the reorganization of the business area and thus did not include the cost of headquarters functions that were transferred from the Navy's three systems commands and inventory management functions that were transferred from the Navy's supply management business area.

## Anticipated Budget Savings Did Not Materialize

Another major contributor to the business area's higher-than-expected overhead costs was the failure to achieve cost reductions and productivity improvement goals that were incorporated into budget estimates. For example, Navy ordnance officials estimate that the business area lost about $13 million in fiscal year 1994 as a result of Defense Management Report Decisions that reduced their cost estimates based on the invalid assumption that (1) the establishment of DBOF would result in a 1-percent reduction in costs and (2) additional savings could be achieved by consolidating automated data processing functions. Because these cost reductions did not materialize, the business area incurred the costs which were not fully recouped by the prices it was charging.

In another case, a DOD budget analyst questioned the Navy's decision to reduce cost estimates based on the assumption that general and administrative costs could be reduced by 3 percent a year during the fiscal year 1996 budget review process. Specifically, the analyst noted that (1) no additional guidance or policy direction, plan, program, or detailed action was provided to show how the savings would be achieved, (2) NOC and the weapons stations had not achieved prior productivity goals that had also focused on overhead costs, and (3) the new savings goal that was not supported by any identifiable plan appeared to be a repeat of the same error. The budget analyst also pointed out that overly optimistic savings assumptions such as these had contributed to the losses that the business area had incurred over the last several years.

## Properly Matching Workload and Workforce Size Is Difficult

A final major cause of the Navy ordnance business area's higher-than-expected overhead costs is that it has not been able to quickly and effectively reduce its workforce to meet the declining demand for goods and services. For example, Navy ordnance officials stated that they incurred losses during fiscal year 1995 because they had to retain unneeded personnel until the workforce could be reduced through either early retirement and separation incentive pay or a reduction-in-force. These officials pointed out that the problem of not being able to quickly reduce workforce levels to meet demand has been exacerbated by their limited ability to control which personnel and skills are retained.

Navy ordnance officials can limit the adverse impact of this problem if they have sufficient time to plan for changes or can use temporary workers. For example, if they could forecast major workload reductions 2 years in advance, they could restrict hiring during the intervening 2 years and, if appropriate, initiate other actions such as offering separation incentive pay or implementing a reduction-in-force. Another possible solution is to use temporary and intermittent[2] workers for all but a core or base-level workload. For example, as of September 30, 1996, 225, or about 37 percent, of the Concord Navy Weapons Station's employees were either temporary or intermittent workers. However, the use of temporary and intermittent workers is much less common at the rest of the business area's activities and, as of September 30, 1996, only 278, or about 7 percent, of the business area's remaining employees were either temporary or intermittent workers.

## Lower-Than-Expected Workload Levels Also Contributed to the Losses

The Navy ordnance business area lost about $39.8 million during fiscal years 1994 through 1996 because lower-than-expected workload levels prevented it from generating enough revenue to recover its overhead costs. According to Navy ordnance officials, overhead costs for such things as the salaries of administrative personnel are generally fixed costs over the short term and are, therefore, usually incurred regardless of the amount of work received during the year. As a result, as shown in table 3.3, a shortfall of 304,617 DLHs of work in fiscal year 1994 resulted in a loss

[2]Temporary workers are hired for a specified period of time, while intermittent workers are permanent employees who are used only when needed.

of about $9.1 million, and a shortfall of 609,793 hours in fiscal year 1996 resulted in a loss of about $30.8 million.

**Table 3.3: Losses Caused by Workload Shortfalls**

| Fiscal year | Workload (DLHs) | | | Budget overhead costs per DLH | Loss (millions) |
|---|---|---|---|---|---|
| | Budget | Actual | Shortfall | | |
| 1994 | 6,915,205 | 6,610,588 | 304,617 | $29.72 | $ 9.1 |
| 1996 | 5,697,500 | 5,087,707 | 609,793 | $50.44 | 30.8 |
| **Total** | **12,612,705** | **11,698,295** | **914,410** | | **$39.8**[a] |

[a]Total is not precise due to rounding.

During the fiscal year 1996 budget review process, which occurred in late 1994, both Navy and DOD budget analysts expressed concern about apparent differences between the Navy ordnance business area's workload estimates and those of its customers. Our analysis showed that these problems continued when the business area's fiscal year 1997 budget was developed. For example, Navy ordnance officials used a workload estimate of 6.3 million DLHS to develop their fiscal year 1997 sales prices, however, after the prices were set, the officials reduced the estimate by about 1.6 million hours, or about 25 percent. As a result, they now expect to incur about $66 million in losses in fiscal year 1997. Chapter 4 discusses this problem in more detail.

## Naval Reserve Units Have Not Provided Expected Level of Support

The Navy ordnance business area lost about $13 million during fiscal years 1994 through 1996 because it had to pay for work that Naval Reserve units were expected to accomplish but did not. This work was to be accomplished as part of a cost savings initiative that was expected to eventually save about $18 million a year. The basic concept was for reservists to accomplish work at weapons stations during their weekend drills and annual training periods and to thereby eliminate the need for about 450 civilians workers. In return for this support, the business area was required to reimburse the Reserve Personnel, Navy appropriation.

The losses occurred because the business area was required by Navy policy to reimburse the Reserve Personnel, Navy appropriation based on expected levels of support that subsequently did not materialize and were determined to be unattainable. For example, Navy ordnance officials estimate that they lost about $6 million during fiscal year 1994 because they paid the Reserve Personnel, Navy appropriation $8 million for the equivalent of 222 years of support but actually received only 58 years of support.

A December 1996 Naval Audit Service report[3] concluded that "The reservists capability to provide contributory support was so limited that no significant savings were achievable and reimbursement for contributory support was not supportable. Our review showed that about 50 percent of the reservists lacked military rating skills for ordnance handling and 51 percent of the reservists had less than 1-year of experience in their reserve billets." The Chief of Naval Operations has subsequently agreed to implement a Naval Audit Service recommendation to discontinue the reimbursement requirement, effective October 1, 1997.

## Conclusions

The Navy ordnance business area has not been able to meet its financial goal of operating on a break-even basis. For fiscal years 1994 through 1996, the business area reported losses of about $212 million primarily because (1) actual overhead costs exceeded budgeted overhead costs and (2) it did not receive as much work as expected. These problems continue to exist and Navy ordnance comptroller officials believe that the business area will incur losses of about $66 million in fiscal year 1997. The Navy ordnance business area will likely continue to increase its prices and/or lose millions of dollars—as it has in the past—until it effectively plans for and reduces its infrastructure costs, especially overhead costs, so that these costs are commensurate with reduced customer demand for ordnance services.

## Recommendations

To ensure that the Navy ordnance business area operates on a break-even basis, we recommend that the Secretary of Defense direct the Secretary of the Navy to develop a plan to streamline the Navy ordnance operations and reduce its infrastructure costs, especially overhead costs. This plan should (1) concentrate on eliminating unnecessary infrastructure, including overhead, (2) identify specific actions that need to be accomplished, (3) include realistic assumptions about the savings that can be achieved, (4) establish milestones, and (5) clearly delineate responsibilities for performing the tasks in the plan.

[3]"Use of and Reimbursement for Reserve Military Manpower at Naval Weapons Stations" (007-97).

## Agency Comments and Our Evaluation

DOD agrees with our recommendation to develop a plan to streamline Navy ordnance operations and reduce its infrastructure costs, especially overhead costs.

# Effective Management and Oversight Requires Accurate and Consistent Financial Information

Having reliable and readily accessible financial management information is essential to the effective and efficient operation of any business entity since it enables managers to account for past activities, manage current operations, and assess progress toward planned objectives. For a revolving fund operation, such as the Navy ordnance business area, this would mean that managers need to have accurate and consistent information on work to be performed and the price charged customers that should reflect the cost of performing the work. Such information would help managers ensure that (1) revenue is based on the amount of work performed and the price charged for that work and (2) revenue approximates the cost of performing the work, in accordance with the goal of operating business areas on a break-even basis. This information could also be used to identify operational inefficiencies so that managers can take appropriate actions.

As noted earlier in this report, for fiscal years 1994 through 1996, the Navy ordnance business area has reported losses of about $212 million and estimates that it will lose about $66 million in fiscal year 1997. We found that management's ability to stem these losses is being hindered by the absence of the essential information we cited above. Specifically, the Navy ordnance business area (1) did not accurately forecast the amount of work to be performed, (2) used a pricing structure that did not allow individual ordnance activities to charge customers prices that represented their estimated cost of doing business, and (3) did not accurately budget and account for costs, especially overhead costs, related to performing work.

## More Reliable Workload Estimates Are Needed

Over the past several years, the difference between the budgeted DLHs and the actual direct hours worked has varied widely. Because prices charged Navy ordnance customers are based, in part, on the projected workload to be performed, fluctuations in the amount of direct work and the type of work performed have resulted in the losses. As discussed in chapter 3, the loss of workload has caused substantial losses because it prevented the business area from recovering its fixed overhead costs. In an attempt to develop more reliable workload estimates, in 1995, the Navy ordnance business area began contacting customers to determine if the customers had identified any changes in the amount of work they expected to give to the Navy ordnance business area. However, Navy ordnance officials estimate that the workload forecast used to develop the fiscal year 1997 prices is overstated by 1.6 million DLHs, or 25 percent of the original forecast. Until the Navy ordnance business area is able to more accurately forecast workload and properly size its workforce to the amount of work it receives, the business area will continue to incur losses.

## Workload Validations Identified Many Problems

The Navy ordnance business area began validating the workload estimates in 1995 because work was not showing up as the customers and the Navy ordnance business area had planned. In 1995, the Navy ordnance business area validated the fiscal years 1996, 1997, and 1998 workload estimates for its major customers and, in 1996, they validated the fiscal years 1997, 1998, and 1999 estimates. The 1995 and 1996 validations determined that the Navy ordnance business area would not receive about 12 percent and 15 percent of the fiscal years 1996 and 1997 forecasted workload, respectively.

Navy ordnance officials informed us that the major reason causing actual workload to vary from budgeted workload is that they begin formulating workload estimates 18 to 20 months before the start of the fiscal year. The Navy Comptroller's office and the Office of the Secretary of Defense adjust the workload estimates with the final adjustments occurring about 9 months before the beginning of the fiscal year. In preparing the workload estimates so far in advance, forecasts of the amount of work to be received from customers are based on assumptions, and thus are not always accurate. For example, (1) the Navy ordnance business area finalizes its workload estimates before the customers' budgets are finalized, (2) the customers' original estimates sometimes represent the total unfunded workload requirements, or unconstrained requirements, which are generally reduced in the budget process because of funding limitations, (3) there is no formal commitment between the customer and the Naval ordnance business area on the amount of work to be performed when the budget estimates are developed, and (4) the customer is not penalized if less work is ordered than originally planned. These workload estimates are used in developing the prices that the business area will charge its customers.

Based on the more recent workload shortfalls and the Navy ordnance workload validations, the Navy ordnance business area has reduced the workforce needed to accomplish work. For example, (1) during fiscal year 1995, the Navy ordnance business area reduced its workforce by 657 through voluntary separations and two reductions-in-force and (2) in fiscal year 1996, the business area did not hire people even though it was authorized to do so. However, the Navy ordnance business area has continued to be optimistic in estimating its workload. For example, about 600,000 DLHs of expected work did not materialize in fiscal year 1996.

## Workload Forecasting Continues to Be a Problem in Fiscal Year 1997

Workload not materializing as planned appears to be a significant problem again for fiscal year 1997. While the Navy ordnance business area estimated that it would receive 6.3 million DLHs during fiscal year 1997, it now believes that it will receive 4.7 million DLHs—a reduction of 25 percent. This has already drastically affected the operation of Navy ordnance departments performing work. For example, in November 1996, at one department of the Yorktown Naval Weapons Station which employed 77 people, 33 people were charging time to overhead cost codes even though they were originally budgeted to perform direct work. Another department shifted 35 staff to overhead because they did not receive work as planned. For example, this department anticipated receiving only $5 million of the $11 million of air launch missile maintenance work it had budgeted for in fiscal year 1997. This was a 55-percent reduction in planned workload.

Due to inaccurate forecasts of work to be performed, the Navy ordnance business area is currently estimating that it will incur $66 million of losses in fiscal year 1997. As discussed above, the workforce reductions have not kept pace with the continuing decline in work. The lower-than-expected workload levels forced the business area to shift many of its direct labor employees to overhead positions and results in the business area generating less revenue to cover fixed overhead costs. This, in turn, will result in the Navy ordnance business area incurring additional losses in fiscal year 1997. The Navy plans to reduce the Navy ordnance business area workforce in fiscal year 1997 to better size it with its estimated workload.

# Uniform Price Structure Is Counterproductive to Efficient Operations

Prior to the establishment of NOC in fiscal year 1994, each weapons station charged customers a price for work performed that reflected the station's estimated costs to do the work, including a surcharge to recoup losses from or return profits to their customers. When NOC was created, the Navy replaced the individual station prices with a uniform price structure. Under this structure, customers pay the same price for like work regardless of (1) where the work is performed and (2) the individual weapons station's cost to perform the work. In addition, each weapons station now shares equally in prior year losses/gains through a standard or uniform surcharge that is included in the price charged customers. The uniform price concept masks the individual weapons station's performance on the monthly financial reports.

The uniform price structure was instituted to help solidify the ordnance business area into a single entity and is not generally used by other depot maintenance business areas. Among other things, the Navy envisioned that uniform prices would discourage Navy ordnance activities from competing with each other for the same customer work and equally spread corporate infrastructure costs over the ordnance business area's workload.

However, the uniform price structure is not consistent with the basic tenet of a business operation and the reasoning behind the DBOF concept: that prices should reflect a specific activity's actual costs of doing business. Instead, as discussed below, the practice of using a uniform price structure, and especially the practice of each station equally sharing losses, distorts the true results of a weapons station's operations and makes it difficult for management to compare operational efficiencies between stations and/or evaluate a station's performance over time. It also diminishes the incentive for a weapons station to operate efficiently.

Table 4.1 shows the disparities between individual weapons station composite prices based on the estimated costs of doing business and the overall NOC composite price charged customers under the uniform price concept. For example, the Charleston Weapons Station was budgeted to make a profit of $13.25 for every DLH of work performed because its $75.78 estimated cost per labor hour is less than the $89.03 estimated overall composite price per hour charged customers under the uniform price structure. Conversely, Earle was budgeted to lose $25.22 for every DLH of work performed because the uniform price precludes Earle from recovering its estimated costs of providing goods and services.

**Table 4.1: Comparison of Individual Weapons Station's Composite Price Per Hour to Overall NOC Composite Price for Fiscal Year 1996**

| Weapons station | Individual weapons station composite price per hour | NOC overall composite price per hour | Difference |
|---|---:|---:|---:|
| Earle | $114.25 | $89.03 | $(25.22) |
| Yorktown | 99.61 | 89.03 | (10.58) |
| Concord | 91.69 | 89.03 | (2.66) |
| Seal Beach | 81.86 | 89.03 | 7.17 |
| Charleston | 75.78 | 89.03 | 13.25 |

The uniform price concept does not allow the ordnance business area's monthly financial reports to present a true picture of a weapons station's financial performance and thus the operational efficiency of the station. For example, the September 30, 1996, financial reports for the ordnance business area showed that Charleston made a profit of $10 million. However, Charleston was budgeted to make about $44 million, which equates to a $34 million shortfall. Because of the uniform price structure, the monthly financial reports make it appear that Charleston was operating efficiently because the reports showed that the station's revenues exceeded its expenses.

Not only does the uniform price structure distort financial reporting, the practice of requiring each weapons station to share equally in recovering the ordnance business area's overall accumulated operating losses in the prices charged customers reduces an individual station's incentive to operate efficiently. Fiscal year-end 1995 financial reports for the ordnance business area showed that the weapons stations' individual accumulated operating results ranged from a positive $6.2 million to a negative $90.4 million, for an overall negative accumulated operating result of about $217 million. Regardless of what activities made a profit or incurred a loss, NOC included a surcharge of $8.28 per DLH in the fiscal year 1996 prices that each weapons station charged its customers. As long as a weapons station can get its high-cost operations subsidized by lower cost stations, the incentive to reduce costs and/or operate more efficiently is significantly diminished.

In discussing the NOC's uniform price structure with Office of the Secretary of Defense (Comptroller) officials, they stated that although there is no written policy regarding the price structure to be used by business areas, the use of a uniform price is "irregular." Specifically, business area activities are supposed to charge customers prices that represent their individual operating costs plus their fair share of the business area's overhead. NOC officials stated that the uniform price structure tends to mask inefficient operations and diminishes the incentive to operate efficiently. We believe that it is time for NOC to reconsider the uniform price structure and return to separate prices based on the individual activity's costs of operations.

## Budgeting and Accounting for Overhead Costs Are Neither Accurate Nor Consistent

Knowing the correct cost of operations, including both overhead and direct costs, is essential for managers to successfully manage business operations and better control costs. However, we found that business area managers do not have such data. Specifically, as discussed below, certain budgeting and accounting practices make it difficult for ordnance managers to (1) ensure that customers only pay for services they receive or benefit from and (2) assess the business area's performance and determine whether it is operating efficiently.

### Inaccurate Allocation of Overhead Costs Benefits Ammunition Storage and Distribution Customers

The Navy ordnance business area's overhead costs have not been properly matched with the appropriate workloads. Specifically, tens of millions of dollars in overhead costs related to storing and distributing ammunition are charged to other workloads, such as engineering and maintenance. As a result of this inaccurate allocation of overhead costs, ammunition storage and distribution customers pay less than they should for the services they receive, while most other customers pay more than they should.

Navy ordnance officials are aware of this problem and, in an attempt to properly identify cost to the benefitting customers, performed a cost restructuring study in which they analyzed the fiscal year 1996 overhead costs for all their major programs. The study found that a substantial amount of the overhead costs was directly related to the weapons stations' basic mission of providing ammunition storage and distribution services to Navy customers. Accordingly, Navy ordnance officials have identified the costs that would remain if all other missions were eliminated. For example, their analysis indicates that most costs related to such overhead functions as inventory management, explosive safety, physical security and fire protection will remain, even if all missions other than ammunition storage and distribution are eliminated.

The cost restructuring study concluded, among other things, that ammunition storage and distribution customers should be charged for about $72 million in overhead costs that are currently charged to other customers. For example, $42 million of overhead costs related to underutilized plant capacity was allocated to all customers even though these costs pertain to various ammunition storage and distribution functions such as pier usage, ammunition storage, and the maintenance of roads and railroads used to transport the ammunition.

While the Navy has not approved this new approach, more accurately allocating overhead costs yields two important benefits. First, it will better match the overhead costs with the related work and, therefore, sales prices will more accurately reflect the cost of doing the work. Secondly, it will highlight the substantial cost associated with maintaining seven separate Navy ammunition storage and distribution facilities.

However, if this cost restructuring initiative is implemented, the customer would need additional appropriated funds to pay the price increases related to the ammunition storage and distribution function. If the customer does not receive these funds, there could be a readiness problem. In fact, there are indications that budget constraints are already creating problems in this area. For example, in an October 1996 message to the business area's Navy ammunition storage and distribution customers, the NOC Commander pointed out that (1) as a result of budget constraints, the Navy planned to fund only $91.8 million, or about 75 percent, of its fiscal year 1997 ammunition storage and distribution requirement and (2) in prior years, the Navy has dealt with funding shortfalls in this area by concentrating on loading and unloading ships, and has neglected functions related to ammunition storage. The message further stated that because of the funding shortfall, the Navy ordnance business area will have problems loading ships during fiscal year 1997.

## Distinction Between Direct and Overhead Costs Is Blurred

The Navy ordnance business area is not accurately budgeting and accounting for costs related to railroad operations. Naval Sea Systems Command guidance entitled NAVSEA Navy Industrial Fund Financial Management Systems and Procedures Manual is not clear on whether train crews should be accounted for and budgeted as overhead. One section of the guidance provides that the labor of individual employees which can be identifiable with a specific service or a customer order be charged to direct labor. However, another section of the guidance specifically states that the pay of train crews be charged to overhead.

According to NOC officials, some weapons station's railroads are used by more than one customer. For example, the maintenance program at a weapons station may use the trains to transport missiles to and from storage in performing missile maintenance work. The officials stated that railroad personnel are classified as indirect labor primarily because it is difficult to allocate personnel costs to the various programs when more than one ordnance program uses the trains. However, at the Earle Weapons Station, railroad personnel costs are considered indirect even though the railroad only performs services for one customer—the Receipt, Segregation, Storage, and Issue program. Specifically, Earle has 15 people in railroad operations performing services such as locomotive engineer and conductor. Because railroad personnel are budgeted as indirect labor, their costs are included in the overhead costs. This has the effect of reducing the number of DLHs charged to the customer using the railroad but increases the hourly labor rates charged that same customer. Consequently, it leaves managers with an inaccurate picture of the actual labor involved in providing a service that involves the trains transporting ordnance.

## Conclusions

Reliable and readily accessible financial management information is essential to the effective and efficient operation of the Navy ordnance business area. For a revolving fund operation, this would mean that managers need to have accurate and consistent information on work to be performed and that the price charged customers should reflect the cost of doing business. However, the Navy ordnance business area (1) did not accurately forecast the amount of work to be performed, (2) used a pricing structure that kept individual ordnance activities from charging customers prices that represented their estimated cost of doing business, and (3) did not accurately and consistently budget and account for overhead costs, especially overhead costs related to the ammunition storage and distribution mission. These practices hamper management’s ability to compare operational efficiencies between weapon stations, evaluate a stations’s or the total business area’s performance over time, or reliably estimate future operating results.

## Recommendations

We recommend that the Secretary of the Navy direct the Navy ordnance business area to discontinue the uniform price structure and develop prices for individual Navy ordnance activities.

We also recommend that the Secretary of Defense and the Secretary of the Navy

- ensure that the workload used in developing prices at the individual Navy ordnance activities are based on more realistic estimates by directing the Navy ordnance business area to (1) continue to validate the workload estimates with customers and (2) compare forecasted to actual work (direct labor hours) received from customers and consider these trends in developing the workload estimates and

- ensure that costs, especially overhead costs associated with the ammunition storage and distribution mission, are accurately allocated to the customers benefitting from the services.

## Agency Comments and Our Evaluation

DOD agrees with our two recommendations to (1) ensure that workload used in developing prices are based on more realistic estimates and (2) ensure that costs, especially overhead costs, are accurately allocated to the customers benefitting from the services.

However, DOD did not concur at this time with our recommendation on setting prices based on costs expected to be incurred by individual activities. DOD cited the need to complete two initiatives in order to more fully consider this recommendation. DOD plans to complete these initiatives by August 1, 1997. DOD plans to address the desirability of establishing individual activity prices as part of a DOD-wide study to address the concerns that the Congress has on DOD Working Capital Funds. The second initiative involves the Navy ordnance business area changing its method of charging ammunition storage and distribution customers. The Navy ordnance business area now plans to charge these customers a cost per ton instead of a cost per direct labor hour, which may result in a more valid comparison of the costs at each ordnance activity.

In conducting these initiatives, DOD needs to consider the incentives that individual activities have for operating efficiently and reducing costs. With regard to the Navy ordnance business area, we believe that as long as NOC retains its uniform price policy, relatively high cost weapons stations will be able to get their operations subsidized by lower cost stations and activities, and the incentive to reduce costs and/or operate more efficiently is significantly diminished. For example, we found that the Naval Warfare Assessment Division (NWAD), which has less overhead costs than the weapons stations and has operated at a profit in recent years, was required to increase its fiscal year 1997 prices from $60.38 an hour to $76.40 an hour, or approximately 27 percent, in order to subsidize more costly activities. Further, if NWAD streamlines its operations and makes a profit, the benefit of this improved efficiency on its future sales prices will be diluted because the savings will be shared with other activities. Under the uniform price policy, if weapons stations collectively have higher-than-expected costs, it is possible that NWAD could streamline its operations and reduce its operating costs, yet still have to increase its prices.

# Comments From the Department of Defense

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER
(Program/Budget)

February 20, 1997

Mr. Gene L. Dodaro, Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Dodaro

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report dated January 17, 1997, "NAVY ORDNANCE: Analysis of Business Area Price Increases and Financial Losses," (GAO Code 511357/OSD Case 1282). Overall the report appears to present a reasonable depiction of the business activities of Navy Ordnance. Of the four recommendations contained within the report, the Department would not agree, at this time, on the recommendation to implement pricing and rates for each individual Naval Weapon Station. The effect of this change is unknown at this time. Furthermore, since Navy Ordnance is in a state of flux and is considering using a different rate structure to more accurately reflect the customer and service provider relationship, a delay until August in order to more fully consider this recommendation would be appreciated by the Department. The attachment provides a more complete response to this specific recommendation. However, the Department supports the basic tenets inherent in all of the recommendations including more accurately identifying workload and costs for Naval Ordnance.

Sincerely,

William C. Coonce
Director for Revolving Funds

Attachment
as stated

**GAO DRAFT REPORT - DATED JANUARY 17, 1997**
**(GAO CODE 511357) OSD CASE 1282**

**"NAVY ORDNANCE: ANALYSIS OF BUSINESS AREA PRICE INCREASES AND FINANCIAL LOSSES"**

**DOD RESPONSE TO THE GAO RECOMMENDATIONS**

- **RECOMMENDATION 1:** The GAO recommended that the Secretary of Defense direct the Secretary of the Navy to develop a plan to streamline the Navy ordnance operations and reduce its infrastructure costs, especially overhead costs. This plan should (1) concentrate on eliminating unnecessary infrastructure, including overhead, (2) identify specific actions that need to be accomplished, (3) include realistic assumptions about the savings that can be achieved, (4) establish milestones, and (5) clearly delineate responsibilities for performing the tasks in the plan (p. 57-58/GAO Draft Report).

  **DOD RESPONSE TO THE DRAFT REPORT:** Concur. The Department agrees with the GAO on the need to develop a plan to streamline the Navy ordnance operations and reduce its infrastructure costs, especially overhead costs. The Department also agrees with the GAO on the need to identify specific actions to be accomplished, inclusion of realistic assumptions regarding achievable savings, establishment of milestones and clear delineation of responsibilities for performing the tasks in the plan. The FY 1998/1999 President's budget for the Navy ordnance business area reflects a significant restructuring and downsizing of the business area while ensuring required DOD capabilities and commitments are supported. The budget addresses specific actions required to streamline the Navy ordnance operations and eliminate unnecessary infrastructure, including overhead.

- **RECOMMENDATION 2:** The GAO recommended that the Secretary of the Navy direct the Navy ordnance business area to discontinue the uniform price structure and develop prices for individual Navy ordnance activities (p. 71/GAO Draft Report).

  **DOD RESPONSE TO THE DRAFT REPORT:** Non-Concur. The Department does not agree, at this time, with the GAO recommendation on the need to direct the Navy ordnance business area to discontinue the uniform price structure and develop prices for individual Navy ordnance activities. The results of a Congressionally mandated study on the Working Capital Funds and a revision of the rate structure for Navy Ordnance will allow the Department to be in a better position to consider the GAO's recommendation. Implementation of the uniform price structure did not contribute to the price increases and financial losses experienced by the business area from FY 1994 to FY 1996. The significant reduction in actual versus projected workload and the inability of the Navy ordnance business area to execute budgeted overhead cost goals were the primary factors contributing the price increases and financial losses experienced during this period. Implementation of the uniform price structure did not reduce Navy ordnance management effectiveness and oversight. Effective management and oversight is achieved through organizational leadership and management commitment to use accurate and consistent financial information related to the cost vice price of doing business. Navy ordnance leadership and management commitment to institutionalize a corporate cost management approach focused on reducing infrastructure costs through the identification and implementation of process improvements will contribute more towards effective management and oversight vice use of individual activity prices. Operating under this type of business philosophy requires management and leadership commitment to institutionalize, standardize, incentivize, export and reward cost efficient and effective behavior.

The rates reflected for the Navy business ordnance area in the President's Budget Submission are the composite or overall rate for the ordnance area. OSD allows the Components the discretion to establish rates for individual activities. The effect of mandating prices for the individual activities is unknown at this time. Currently, an DoD-Wide Congressional Study Group is addressing the concerns of the Congress with respect to the Defense Working Capital Funds. Part of the study will address the desirability of establishing individual activity rates. Furthermore, for ordnance two sets of rates will be established beginning in FY 1999. The first will be the cost per ton shipped or received for all Receipt, Segregation, Storage and Issue (RSSI) workload. The remaining work loads not included in the RSSI work load will continue to operate on a fully burdened cost per direct labor hour basis. The Department would like the opportunity to assess the effect of this recommendation on the operation of the ordnance activity using the Congressional Study Group as the forum. Also, the establishment of the new rate structure for RSSI workload might allow a more valid comparison of the costs at each ordnance activity. The completion of these two initiatives is August 1. At that time the Department will be better able to respond to the GAO recommendation.

- **RECOMMENDATION 3**: The GAO recommended that the Secretary of Defense and the Secretary of the Navy ensure that the workload used in developing prices at the individual Navy ordnance activities are based on more realistic estimates by directing the Navy ordnance business area to (1) continue to validate the workload estimates with customers and (2) compare forecasted to actual work (direct labor hours) received from customers and consider these trends in developing the workload estimates (p. 71-72/GAO Draft Report).

  **DOD RESPONSE TO THE DRAFT REPORT:** Concur. The Department agrees with the GAO on the need to validate workload estimates with customers and consider workload trends when developing future workload estimates and setting prices for the Navy ordnance business area. The Navy ordnance business area will continue to refine and formalize the annual workload validation process it performs to support workload projections and customer prices used to develop its budget estimates.

- **RECOMMENDATION 4**: The GAO recommended that the Secretary of the Defense and the Secretary of the Navy ensure that costs, especially overhead costs associated with the ammunition storage and distribution mission, are accurately allocated to the customers benefiting from the services (p. 72/GAO Draft Report).

  **DOD RESPONSE TO THE DRAFT REPORT:** Concur. The Department agrees with the GAO on the need to accurately allocate the total costs of the ammunition storage and distribution mission to the customers benefiting from the services. Effective FY 1999, the Navy ordnance business area will establish and implement a new unit cost to be charged for all ammunition storage and distribution mission (known as Receipt, Segregation, Storage and Issue or RSS&I) workload. This unit cost will be based on a cost per ton shipped or received. This unit cost will ensure the RSS&I workload finances the total costs of the ammunition storage and distribution infrastructure from which it benefits.

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